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FARM CREDIT ADMINISTRATION
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SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

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Income tax returns are required to be rendered in accordance with the method that the taxpayer uses in keeping the books and records of the business. There are two methods of rendering returns: the cash receipts and disbursements method and the accrual method. If the method of accounting regularly employed by the taxpayer in keeping his books clearly reflects his income, the return should be rendered on that basis (Regulations 111, Sec. 29.41-1). When a taxpayer has once adopted a method of keeping his books and rendering his returns, he may not change the method without obtaining the consent of the Commissioner (Regulations 111, Sec. 29.41-2).

There must be no arbitrary departure from the method adopted. There should be reasonable consistency. In Hyams Coal Co., Inc. v. United States, 26 F. 2d 805, 808, it was said in part:

> "* * * The accrual basis, once adopted, must be consistently adhered to by the taxpayer. The courts have recognized this consistency and denounced any practice that would result in computing taxes attributable to a given year, using the cash basis for a part and an accrual basis for the balance of the year. The law contemplates consistency in the keeping of books once a method is adopted."

In United States v. Anderson, 269 U.S. 422, 440, the Supreme Court refers to the difficulties involved in the preparation of an income account, on a receipts and disbursements basis for a business of any complexity. In this case the Government's brief contained an admirable statement of the accrual system to the following effect:

> "Under the accrual system of accounting income is said to be accrued when it is definitely receivable although its payment may not be due, and liabilities or expenses are said to be accrued when the events have occurred from which liability is determined and the liability has become fixed even though payment is not yet due. The basic idea under the accrual system of accounting is that the books shall immediately reflect obligations and expenses definitely incurred and income definitely earned, without regard to whether payment has been made or whether payment is due. Under this system the use of the word 'accrued' does not signify that the item is due. On the contrary the accrual system wholly disregards due dates."

In the same case the accrual of a tax that had not yet been assessed was discussed. The court said (page 440):

> "Only a word need be said with reference to the contention that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued."

Chief Justice Hughes in Spring City Company v. The Commissioner, 292 U.S. 182, 183, defined the accrual basis as follows:

> "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. When a merchandising concern makes sales, its inventory is reduced and a claim for the purchase price arises."

If a taxpayer is on the accrual basis it does not make any difference when he actually receives payment of the items due, and it is entirely possible that in many instances payment will be actually received in one tax year with respect to an indebtedness upon which the tax has already been paid in a previous year because of the fact that the accrual system is used.

On the cash receipts and disbursements basis, amounts actually received and disbursed are to be taken into account. This system ignores the time when income is earned.

However, while the cash basis covers actual receipts and actual disbursements, it also includes constructive receipts. Constructive receipt occurs when income is unconditionally made available to the taxpayer, or, as it is sometimes stated, "unqualifiedly made subject to his demands." This theory has been recognized in the regulations of the Bureau of Internal Revenue (Regulations 111, Sec. 29.42-2) and sustained many times in the courts. The reason for the existence

of such a rule is well and briefly stated by the Circuit Court of Appeals for the Eighth Circuit in Loose v. United States, 74 F. 2d 147, 150, where the court said:

> "Not recognizing constructive receipt of income as income realized would open the door to fraud by leaving it in the power of the taxpayer to reduce income to possession at such time as would best suit his taxation purposes. Such right of selection does not rest with the taxpayer, nor does it find approval in the cases." (Citing authorities).

In this case the court held that the failure of a decedent to clip coupons that were past due did not justify his executrix in excluding them from his income for the year during which they became due.

Income may become taxable to a taxpayer making his tax returns on a cash basis under some circumstances even before it becomes payable. An instance is involved in the case of Herbert v. Commissioner of Internal Revenue, 81 F. (2d) 912. In this case the taxpayer was the sole stockholder of a corporation. During the month of December 1930, it declared a dividend payable on January 10, 1931. Instead of waiting for the due date, however, the stockholder had his corporation make an entry on its books before the close of the year 1930, applying the dividend to an existing indebtedness of the taxpayer to the company. The court held that in veiw of this fact the dividend was received and used by the taxpayer during 1930 and tax taxable to him in that year.

The case of A. D. Saenger, Inc. v. Commissioner, 84 F. (2d) 23, presents another instance where a dividend was held to have been constructively received. The court referred to the ruling of the Treasury that dividends are to be considered received by a stockholder even though he may be on a cash receipts basis when they are unqualifiedly made subject to his demand. This case presents an instance where the decision went further than might ordinarily be anticipated. It appeared from the facts that the corporation did not carry cash on hand sufficient to pay what it had put to the credit of its stockholders. It is interesting to note that in this case additional action would have been necessary on the part of the corporation declaring the dividend before the amount could have been made available to the stockholders. The court suggested in this case that the corporation declaring the dividend could on demand have borrowed the amount necessary to pay it, or could have raised it by the sale of some of its investments.

A case in which the time of the declaration of a dividend did not control and give rise to the application of the theory of constructive receipt is Avery v. Commissioner, 292 U.S. 210. The reason for

the court's refusal to apply the theory of constructive receipt in this case was because the evidence very clearly showed that while the dividend was payable on December 31 of one taxable year, and the dividend checks were dated on that date, they were not mailed out by the Company and accordingly could not by any possibility have been deposited to the credit of the respective stockholders before the ensuing year. The controlling facts were stated in the following language, page 212:

> "The dividend checks never left the treasurer's office or went to the mailing department until the afternoon of the last day of the month. They were mailed on the last day of the month so as to be in the stockholders' hands on the first business day of the following month. The practice was without exception that no stockholder, whether employee or officer, should receive his check before the first business day of the month following the month in which the dividend was made payable."

The theory of constructive receipt is not to be confused with accrual. In Gatliff v. Helburn, 31 Fed. Supp. 495 the taxpayer contended that the application by the Commissioner of the theory of constructive receipt had the effect of changing the basis of rendering the return from a cash to an accrual basis. In declining to recognize this contention the court said, page 497:

> "The Treasury Regulation N. 45, Article 23, promulgated under the Revenue Act applicable to the years involved, provides: 'A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction.' The application of this regulation did not have the effect of changing the accounting basis from that upon which the taxpayer elected to make the report. Income to which the regulation was properly applicable was regarded as constructively received rather than as accrued.
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> * * * * *
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> "The plaintiff claims, however, that the Commissioner's act in assessing the total amount posted on the books rather than the amount actually paid had the effect of arbitrarily converting the accounting basis of the report from that of cash receipts and disbursements to that of accrued receipts and disbursements, and consequently the taxpayer is entitled, as against her gross income so assessed by the Commissioner, to take credit for a large amount of indebtedness which she alleged,

> although not paid until many years later, had accrued against her in the years 1920 and 1921 under contracts by which she was bound for minimum royalties to one J. B. Lewis, Trustee. As already pointed out, the Commissioner did not alter the basis of the plaintiff's return so as to convert it to an accounting on the accrual basis, hence the claim that the taxpayer is entitled to deduct accrued but unpaid debts must be denied."

Where the amount to which a taxpayer is entitled is indefinite, or there is a definite contingency as to the receipt of such amount, there can be no constructive receipt (A. Naitove & Co. v. Commissioner of Internal Revenue, 32 F. (2d), 949.

In connection with the receipt of income, whether actual or constructive, it must be noted that in order that receipts shall give rise to tax liability it is not necessary that they be in money. There may also be receipts of other property which will be taxable provided it has a fair market value at the time of receipt.

On this subject one of the contemporary text book writers has the following comments to make:

> "It is obvious that the determination of income when the so called cash receipts basis is used must take into account income received in the form of property as well as cash; that is, it must include both cash and its equivalent. *** It does not follow because a taxpayer has received property which has a cash equivalent that it is necessarily taxable. The theory is applicable only where there would have been a tax if cash had been received." (Mertens, Vol. 2, 11-01.)

The statement quoted is somewhat broad, but is not to be interpreted as broadly as it is put. The phrase, "income received in the form of property", is of course not intended to imply that all property received in lieu of cash that would be income is taxable as income. If it has no readily realizable market value it cannot be taxed. It has been said that to speak of property as being the equivalent of cash is a misnomer -- that the expression simply means that property has been received having a fair market value.

The most common instances of receipts other than cash that are to be regarded as cash are notes. In Pinellas Ice Co. v. Commissioner, 287 U. S. 462, part of the purchase price for certain property was paid in cash and the balance was paid by delivery of the purchaser's three promissory notes secured by the deposit of mortgage bonds. The notes were payable with interest in 45, 75 and 105 days respectively. The court said:

"It would require clear language to lead us to conclude that Congress intended to grant exemption to one who sells property and for the purchase price accepts well-secured, short-term notes, (all payable within four months), when another who makes a like sale and receives cash certainly would be taxed. We can discover no good basis in reason for the contrary view and its acceptance would make evasion of taxation very easy. In substance the petitioner sold for the equivalent of cash; the gain must be recognized."

This decision has been followed in other cases. See Wolfson v. Reinecke, 72 F. 2d 59.

The general rule is also subject to the qualification that only when property is received in lieu of cash that would have been received under circumstances which would have rendered it taxable income and when the property has a readily realizable market value, that it is considered as the equivalent of cash and taxed accordingly.

On the question of market value the case of Whitlow v. Commissioner, 82 F. 2d 569, is of interest. In this case the question arose as to the market value of certain long-term notes. Witnesses testified that the notes had no market value, in the sense that one could not go out on the market and sell them for par or any where near it. In summing up the evidence the court said the result of this would be that there would be no current prices by which market value could be determined, and stated that in such a situation the definition of market value would be "the sum that would in all probability result from fair negotiations between an owner who is willing to sell and a purchaser who desires to buy."

The court then observed that the main factor in determining the value of notes such as those in issue would be the probability of their being paid when due. From the evidence the court inferred that it might reasonably be supposed that the notes would be paid. Further, it was known at the time the case was before the court that the notes had been paid - a circumstance, however, that even though known at the time could scarcely have been permitted to affect the decision.

If the Commissioner of Internal Revenue is in any case not satisified of the correctness of a taxpayer's contention that property received has no market value, or is dissatisfied with the taxpayer's valuation, he may make his own determination and his determination is prima facie correct and the burden rests on the taxpayer to show that the property received had no market value (U.S. v. Anderson, 269 U.S. 422), but if there is insufficient evidence to sustain the Commissioner the courts will reverse his determination (Nichols v. Commissioner, 44 Fed. (2d) 157.

A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner of Internal Revenue (Regulations 111, Sec. 29.41-2).

In the case of American Box Shook Export Association v. Commissioner of Internal Revenue, ______ F.2d ______, the Circuit Court of Appeals for the Ninth Circuit on June 27, 1946, affirmed the decision of The Tax Court of the United States, 4 T.C. 758 (Summary No. 29, page 1), holding that the association must pay income taxes on patronage refunds amounting to $7,559.11 which it had paid in cash to its members. The following quotations from the opinion of the Circuit Court of Appeals show the basis therefor:

> "Petitioner is an association, formed under the general corporation laws of California, to export box shook for its stockholders who are companies engaged in the manufacture or distribution of lumber products. Petitioner asserts that it bought its shook from its stockholders under an agreement with them for what, in effect, is a double consideration. (a) When petitioner receives a foreign inquiry for box shook it asks one or more of its group of sellers for its minimum price. If this price is acceptable, it is paid to the seller and the title passes to petitioner. (b) When petitioner resells to the foreign buyer, it is obligated to pay to its seller a further consideration computed as follows: From the profits of all the sales of shook in the corporate fiscal year it deducts its expenses and gives to each seller a share based upon the ratio of the footage of shook resold for each seller to the total footage of shook resold.
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> "In petitioner's fiscal year ending May 31, 1941, it made distributions to its stockholders out of earnings of that year totalling $7,559.11. In its income tax return petitioner reported total income of $50,865.03 and net taxable income of $13,317.66. It did not include in its gross income either the amounts distributed to the members during that year or the sum of $4,000 entered in its books as a reserve for anticipated claims. The commissioner held that the sums of $7,559.11 and $4,000 should have been included in its income for that year and assessed a deficiency for these amounts. (At the hearing it conceded the non-deductibility of the $4,000 sum if it is determined that it is taxable.)
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> "Before the Tax Court, petitioner originally claimed that the payments to its stockholders should not be taxed because they were in the nature of rebates or patronage dividends within the rule of Midland Cooperative Wholesale, 44 B.T.A. 824. Later petitioner argued that it was a marketing cooperative and all the income it received was income of its stockholder-members and not its own income.
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> "The Tax Court considered both contentions and held (1) that the income received by petitioner was not the income of its stockholders, and (2) that sums which it distributed to the stockholders during the taxable year could not be deducted or excluded from gross income.
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> "We conclude that the primary question before this court upon this appeal is whether there is evidence in the record to support the Tax

Court's conclusion that all of petitioner's income is its own within the meaning of Section 22 (a) of the I.R.C. Viewed in this light, we are of the opinion that the rule announced in Kelly Co. et al. v. Commissioner, Supreme Court January 7, 1946; Commissioner v. Scottish American Co., 323 U.S. 119; Dobson v. Commissioner, 320 U.S. 489 is binding upon us and calls for affirmance.

"The Tax Court cites its earlier decisions in which the court had excluded from the gross income of cooperative marketing associations patronage dividends or rebates payable to their patrons. See Midland Cooperative Wholesale, supra; United Cooperatives, 4 T.C. 93; and also, Fruit Growers Supply Co., 21 B.T.A. 315, 326, affirmed, 9 Cir., 56 F.2d 90, 93. <u>In order to be a true cooperative, however, the decisions emphasize that there must be a legal obligation on the part of the association, made before the receipt of income, to return to the members on a patronage basis, all funds received in excess of the cost of the goods sold. Such an obligation may arise from the association's articles of incorporation, its by-laws, or some other contract.</u>

"The Tax Court held in this case that there was no legally binding obligation upon the association to return to its stockholders in the form of patronage dividends, its income, over expenses and a reserve for future claims. The Tax Court found that neither petitioner's articles of incorporation, nor its by-laws required such repayment. The Tax Court also concluded that the informal 'understanding' between petitioner and its stockholders was not a legally binding obligation requiring petitioner to repay to its stockholders all income after deducting expenses and a reserve for future claims. Petitioner maintains upon this appeal that the evidence will not support any conclusion except that the 'understanding' was a binding contract. Therefore, petitioner argues that all income received by the association was in reality income of the stockholders.

"We cannot agree with petitioner. On the subject of the 'understanding' the Tax Court held that although petitioner's witnesses spoke of an understanding between the association and its stockholders, the understanding was not carried out in practice. This conclusion could well be inferred by the Tax Court from the evidence. During the taxable year, petitioner distributed $7,559.11 to its stockholders and placed $4,000 in its reserve. Yet it reported a taxable income, after deducting both of these items, of $13,317.66. There is no specific evidence to show what was to be done with this amount. The evidence does not show that it was set up as a reserve fund which was prorated among the stockholders at any time. Under petitioner's corporate set up, the sum could be used for the payment of dividends, or other corporate purposes." (Underscoring added.)

This case emphasizes that in order to have a true cooperative association, money received by an association from business done with one patron, whether member or nonmember, should not be turned over to another patron at any time, either currently or in dissolution. It emphasizes that in a true cooperative

each patron should receive "returns" -- using that word in a broad sense of <u>all amounts</u> over his share of operating and maintenance costs and expenses -- in accordance with the business which he has done with the association, whether the returns are paid in cash or are held in the business, and that in order to have a true cooperative association the association must be under a positive, enforceable obligation to account to each patron on the basis just outlined.

In other words, it is not enough that an association, as a matter of grace, may make distributions even though they are made in cash on a patronage basis. It must be under a firm, mandatory obligation to make such distributions if the association desires to exclude them in computing its income taxes.

In the case of <u>Fruit Growers' Supply Co.</u> v. <u>Commissioner of Internal Revenue</u>, 56 F.2d 90, the Circuit Court of Appeals for the Ninth Circuit affirmed the decision of the Board of Tax Appeals, now The Tax Court of the United States, 21 B.T.A. 315, and in doing so said:

> "* * * We agree in this regard with the conclusions of the Board of Tax Appeals which we quote as follows: 'The petitioner now asks that we increase the patronage-dividend deduction on account of an amount which has not been returned to the members and when no dividend declaration has been made with respect thereto. We find nothing in the petitioner's by-laws which would cause these patronage dividends to accrue as such without corporate action setting them apart as a liability of the petitioner to its members. The by-laws provide that it shall be the duty of the directors to "declare dividends out of surplus profits when such profits shall, in the opinion of the directors, warrant the same, subject to the provisions" of another section wherein it is provided that the directors are authorized to prescribe "the time and manner of readjustment with or refund to its patrons." A reasonable interpretation of the foregoing would seem to be that corporate action is required before patronage dividends accrue, and this conclusion is consistent with the minutes of the board of directors for the various years here involved.'"

It is clear from the foregoing quotation that the Fruit Growers' Supply Company, which was held to be a nonexempt organization, was not under a firm obligation to pay patronage refunds to its patrons, and because of this fact the court held that certain amounts which had been kept in the business were not deductible in computing the income taxes to be paid by that company.

In the foregoing quotation it will be observed that the court said that it found "<u>nothing in the petitioner's by-laws which would cause these patronage dividends to accrue as such without corporate action setting them apart as a liability of the petitioner to its members.</u>" (Underscoring added.) If no liability to its patrons arises before corporate action has been taken by the board of directors of an association, this would mean that the association was not under a firm obligation to account to its patrons on a patronage basis

and hence if the association was nonexempt the amounts which it might distribute, even though paid in cash, would not, under the holdings of the courts, be excludable in computing its income taxes.

If the book value of the stock, held by Richard Roe in a stock corporation, is increasing due to its normal current business with other patrons, or if the property rights and interests of Richard Roe in a nonstock association are likewise increasing, this would make it clear that the association is not under a mandatory obligation to account to its patrons for the excess over the share of the operating and maintenance costs and expenses of the association which should be borne by each of them. The directors and officers of an association must have no discretion with respect to the disposition to be made of this excess, but the association must be legally obligated to account to each of the patrons on a patronage basis therefor if such amounts are to be excluded or deducted in computing the liability of a nonexempt association for income taxes.

In the case of Commissioner of Internal Revenue v. Wilcox, 90 L. Ed. 553, the Supreme Court of the United States held that money which had been embezzled by Wilcox was not income to him, and that therefore he was not required to pay income taxes thereon. In reaching this conclusion the court among other things said:

> "For present purposes, however, it is enough to note that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain." (Underscoring added.)

The court pointed out that as a matter of law Wilcox was under "a definite unconditional obligation to repay or return" the money which he had embezzled, and this was one of the reasons that the money did not constitute taxable income in his hands.

For a nonexempt association to come within the scope of the principle stated in tho quotation from the Wilcox opinion it must be under an "unconditional obligation" to account to its patrons on a patronage basis for all amounts received in its normal business operations over and above its operating and maintenance costs and expenses.

In the case of many associations the payment of patronage refunds or dividends in cash, in stock, or other "credits" of some kind, is purely a matter within the discretion of the board of directors of the association. Obviously such an association, if it is not eligible for exemption from the payment of Federal income taxes, as a matter of law cannot deduct or exclude patronage refunds or dividends, even though it pays them in cash, in computing its income taxes. If the organization papers are properly drawn all amounts received by an association over and above its operating and maintenance costs and expenses may be received as capital and allocated on a patronage basis among its patrons, and evidenced by stock or otherwise. Of course, capital may be revolved if the organization papers provide for doing so. Money received as capital is not income from the standpoint of income taxes. See "Capital or Income", Summary No. 30, page 1.

La Societe Francaise De Bienfaisance Mutuelle brought suit against the United States of America and obtained a judgment for the amount of social security taxes which it had paid under protest. This judgment was based "upon a finding that the Society was organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual within the meaning of §§ 811 (b)(8) and 907(c)(7) of the Social Security Act."

The Government appealed the case and obtained a reversal in United States v. La Societe Francaise De Bien Mut., 152 F.2d 243. The Government sought a reversal "because the record shows that a 'part of the net earnings of . . . (the hospital) inures to the benefit of . . . individual' members of the appellee corporation, and that the hospital is not 'operated exclusively' for charitable purposes."

Section 811(b)(8) of the Social Security Act, 42 U.S.C. Sec. 1011(b)(8) reads as follows:

> "(b) The term 'employment' means any service of whatever nature, performed within the United States by an employee for his employer, except --
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> * * * * * * *
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> "(8) Service performed in the employ of a corporation, community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual. * * * "

The Society was engaged in the operation of a large general hospital in San Francisco to which the general public as well as members were admitted, a school for nurses, and a home for aged members. The court said that:

> "Membership in the Society is limited to those 'of French birth, or descendants of French or speaking French, sound in mind and in body, and less than 50 years old.' Members pay an admission fee and monthly dues and in return receive medical treatment and hospital care gratuitously or at less than the normal cost charged nonmember paying patients admitted to the Society's hospital. Only members in good standing receive these privileges and if a member is six months in arrears on his dues he loses his privileges although some indigent members and their families may be treated free of charge at the discretion of the board of directors."

It appeared that the Society in 1940 had a total income of $409,630.17, approximately 37% of which was received from fees paid by nonmembers for hospitalization, and the balance was received from members' dues, admission fees charged

members, fees charged members for hospitalization, dividends, interest, and rent on investments of the Society, and gifts and bequests to it. In 1944 the total income of the Society was $680,448.50, of which approximately 67% was paid by nonmembers for services. Although the Society some years had operated in the red, in 1944 receipts exceeded disbursements by nearly $70,000.

In holding that the Society was not operated exclusively for charitable purposes, the court said in part:

> "In the case of Better Business Bureau of Washington v. United States, 66 S.Ct. 112, 114, the Supreme Court of the United States construed the statute under consideration here. In Better Business Bureau v. United States, supra, the Supreme Court was concerned with the word 'educational' as it appears in § 811(b)(8) of the Social Security Act. We think the reasoning applies with equal force to the word 'charitable' with which we are concerned here. The Supreme Court in Better Business Bureau v. United States, supra, had this to say, 'In this instance, in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes.' So in the instant case, in order for the Society to fall within the claimed exemption it must be devoted to charitable purposes exclusively and if we find in its operations a single non-charitable purpose, substantial in nature, though it may have numerous 'truly' and important charitable purposes, it cannot be granted the exemption sought.
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> "The by-laws of the French Mutual Benevolent Society state 'the society is founded on the basis of mutuality for the treatment of sick members * * *.' The underlying purpose of its organization, as we understand it, was to afford its members the best possible medical, hospital and surgical attention at the lowest possible cost. Recognizing the financial return that would be available by expanding its activities so as to make available to nonmembers its facilities for treatment it entered that field. This resulted in greatly increased operations and greatly increased income and feeling that its members should benefit from this enlargement of its business it charged a greater fee for nonmembers than for members. This assisted in the betterment of its plant and all other facilities which afforded the opportunity for more complete and better treatment of members at lower cost, a service which inured to the benefit of members. (This underscoring added.)
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> "This service was of value. The proceeds that made it possible flowed from the business venture of treating non-members. Such business venture is not a charity in any sense of the word. (Under scoring added.) No member of the Society in receiving the more adequate treatment at a lower cost would consider himself an object

of charity but rather that he was reaping the benefit of a wise decision in electing to become a member of an organization which, through its well-managed business activities, had made the added results available to him. The receipt of 37% in 1940 and 67% in 1944 of the total income from non-members demonstrates that the activities of the Society in the non-charitable line was quite considerable and quite substantial.

"The Society has never paid dividends to anyone but profits may inure to the benefit of a private share holder other than by monetary dividend payments. (Underscoring added.) Northwestern Municipal Association, Inc., v. United States, 8 Cir., 99 F.2d 460.

"The case of United States v. Proprietors of Social Law Library, 1 Cir., 102 F.2d 481, is relied on by the Society, but the Government correctly points out this distinction: 'There are points of similarity in the cases. But the vital one is lacking -- the proprietors did not benefit at the expense of the outsiders.' (Underscoring added.)"

As pointed out in the foregoing quotation, the court specifically held that because the members were profiting from the higher amounts charged nonmembers, that this meant that the Society was not being operated exclusively for charity. In brief, the court held that this was a commercial activity. Of course, if the payments received from nonmembers had been sufficient in amount it might have operated to relieve the members from making any payments for services at all. The Society paid no dividends, but as pointed out in the foregoing quotation, profits may inure to the benefit of a private shareholder although not received in the form of monetary dividends.

The Society, after it had been notified that it was not liable for the payment of taxes under the Social Security Act, refunded to its employees all contributions which it had theretofore deducted from their wages. In holding that the Society was not only liable to the Government for the amount of the social security taxes which it was required to pay but also for the amounts it was required to deduct from the wages of its employees, the court held that the erroneous ruling of the Commissioner of Internal Revenue did not operate to estop the Government from requiring the Society to pay the amounts in question. In this connection the following quotation is taken from the opinion:

"After receipt of the official notification of July 14, 1937, wherein the Society was informed that it was not liable for payment of taxes under the Social Security Act, the Society refunded to its employees all contributions which it had theretofore deducted from their wages pursuant to the requirements of the act and discontinued making such deductions until April 3, 1939, the date the Society received notice it was not exempt from social security payments.

"It is the general rule that the federal Government does not lose its revenue because of the erroneous ruling of an administrative official; hence, the Commissioner of Internal Revenue was not estopped from changing his ruling that the Society was exempt. Burnet v. Porter,

> 283 U.S. 230, 51 S.Ct. 416, 75 L.Ed. 996; Baumgartner v. Com'r, 9 Cir., 51 F.2d 472; United States v. Tuthill Spring Co., D.C., 55 F.2d 415; National Rifle Association v. Young, 77 U.S. App.D.C. 290, 134 F.2d 524; Chiquita Mining Co. v. Com'r, 9 Cir., 148 F.2d 306. The fact that the Government should not be estopped is supported by the fact that we have no way of knowing whether or not all of the facts now known to us were presented to the Commissioner and it may well be that under the facts then before him the Commissioner ruled correctly." (Underscoring added.)

In the case of an agricultural cooperative association that desires to meet the conditions for exemption from the payment of income taxes, it will be remembered that nonmembers must be treated in all respects, including prices paid or charged, patronage refunds, and interest in reserves, the same as members; and that members may not profit from the business done with nonmembers if an association is to remain eligible for exemption.

In the case of In re Farmers' Union Hospital Association of Elk City, decided by the Supreme Court of Oklahoma, 126 P.2d 244, the question was presented of whether a cooperative hospital was operated as a benevolent or charitable institution and hence was entitled to exemption from the payment of ad valorem taxes. The court held that the hospital was not exempt, and the reasoning of the court was similar to that in the foregoing case. It appeared that nonmembers of the cooperative hospital paid a much higher rate than members. Such higher rates accrued at least in part to the private advantage of the members. The court said in part:

> "In speaking of private advantage as being a factor that precludes any organization from assuming the status of a charitable or benevolent institution, we mean private advantage to the organizers, and the supporters thereof. The fact that a profit is realized from the operation of a hospital does not condemn the scheme as non-charitable or non-benevolent. It is the use to which the profit is put that means much. In this case some of the profits is used to increase the facilities and some to the reduction of the cost to the members. This is a private advantage." (Underscoring added.)

In the case of Michigan Wolverine Student Cooperative, Inc. v. Wm. Goodyear & Co., decided by the Supreme Court of Michigan, 22 N. W. 2d 884, the question for decision was whether a deed to real estate executed by the officers of the cooperative association, in pursuance only of a resolution of its board of directors authorizing its officers to sell such real estate was valid without the approval or ratification of its members. It appeared that the cooperative association was a nonprofit organization functioning for the benefit of students of the University of Michigan, at Ann Arbor, Michigan. It owned certain real estate in Ann Arbor and for a time operated a restaurant on the first floor and rented rooms on the second floor. Due to war conditions there had been a decline in the membership of the cooperative association, such membership being restricted to students attending the University of Michigan. The association, for a considerable period of time, had operated in the red but was not insolvent. Its board of directors met and adopted resolutions authorizing the officers to sell the restaurant equipment and adopted another resolution authorizing its officers to sell the real estate.

No question was raised regarding the validity of the sale of the personal property. A meeting of the members was held at which they refused to approve of the sale of the real estate. On the contrary, a suit was brought by the cooperative to set aside the deed which its officers had executed to the real estate. The court said:

> "It is conceded that plaintiff was and is a corporation formed and existing under the provisions of the general corporation law, Act No. 327, Pub. Acts 1931. Section 57 of this act, Stat. Ann. § 21.57, provides: "Every corporation formed or existing under this act may sell, lease or exchange all or substantially all of its property and assets, including its good will and its corporate franchises, upon such terms and conditions and for such consideration, which may be in whole or in part shares of stock in, and/or other securities of, any other corporation or corporations, domestic or foreign, as its board of directors shall deem expedient and for the best interests of the corporation, when and as authorized by the affirmative vote of the holders of a majority of the shares issued and outstanding given at a shareholders' meeting duly called for that purpose, or when authorized by the written consent of the holders of a majority of the shares issued and outstanding: Provided, That the articles may require the vote or written consent of the holders of a larger proportion of the shares issued and outstanding."

The statutory provision just quoted, on its face, requires "the affirmative vote of the holders of a majority of the shares issued and outstanding given at a shareholders' meeting duly called for that purpose, or when authorized by the written consent of the holders of a majority of the shares issued and outstanding" to authorize the sale of "all or substantially all of its property and assets" etc.

Under familiar rules of statutory construction, the court said that under the foregoing statutory provision "no other or greater power is given to boards of directors by the statute than as thus specified therein." The defendant argued that, at common law, the board of directors of a corporation which was in financial distress or in failing condition might sell all of its assets without action by the members or stockholders of the corporation. The court, however, apparently was of the opinion that the statute was controlling. In this regard the court said:

> "The statute does not authorize the board of directors of a corporation to sell all or substantially all of the corporate assets whenever, in the opinion of the directors, the corporation is not a going and prosperous concern, or is in a failing condition. If a corporation is no longer a going concern the statute provides several methods whereby the corporation may wind up its affairs, dispose of its assets, and cease to exist. None of these methods authorizes a board of directors to wind up corporate affairs and dispose of the assets without action by the stockholders, or by a court. See Act No. 327, § § 65-73, Pub. Acts 1931, Stat. Ann. § § 21.65-21-73; 3 Comp. Laws 1929, § 15310 et seq., Stat. Ann. § 27.2354 et seq."

Moreover, the court was of the opinion that although the cooperative had been operating in the red, that it was not in such financial distress as would even at common law authorize the board of directors to sell all of the assets without the consent of the members. In this regard the court declared:

> "The decisions from other jurisdictions and statements of text writers, relied on by defendant to establish the common-law exception to the statute, usually refer to circumstances quite different from those here involved. Some cases refer to the absence of statutory provisions, to insolvency, or where the action was brought by either a minority stockholder, or by the majority."

The court quoted with approval the following:

> "At common law neither the directors of a corporation nor a majority of its stockholders had the right, power, or authority to sell and convey all the property of a going and prosperous corporation capable of achieving the objects of its creation as against the objections of a single stockholder. Forrester v. Boston, etc., Mining Co., 21 Mont. 544, 55 P. 229, 353; Bulkley v. Big Muddy Iron Co., 7 Mo. App. 589; Price v. Holcomb, 89 Iowa 123, 56 N.W. 407, City of St. Louis v. St. Louis Gaslight Co., 70 Mo. 69; Byrne v. Schuyler Electric Mfg. Co., 65 Conn. 336, 31 A. 833, 28 L.R.A. 304; Tillis v. Brown, 154 Ala. 403, 45 So. 589; Kean v. Johnson, 9 N. J. Eq. 401, 1 Stockt. 401; Smith v. Stone, 21 Wyo. 62, 128 P. 612; Taylor v. Earle, 8 Hun, N.Y., 1; Abbot v. American Hard Rubber Co., 33 Barb., N.Y., 578."

The court was of the opinion that the method of sale provided for in the statute was exclusive. In this respect the court said:

> "The case is controlled by section 57 of the general corporation act, supra. The consent or approval of a majority of plaintiff's members was essential to the authority of the board of directors to effect the sale of the real estate in question. Lacking such authority, the attempted sale is void."

Whenever a purchaser is buying all or substantially all of the assets of a corporation care must be exercised to see to it that the corporation complies with all requirements, statutory and otherwise, applicable to a sale of assets under these conditions.

Embalming a Business -- Not a Profession

In State v. Winneshiek Cooperative Burial Association, decided by the Supreme Court of Iowa, 22 N.W.2d 800, it appeared that the Attorney General of the State brought quo warranto proceedings to oust the cooperative burial association on the ground that it was practicing a profession in violation of law and against public policy. The trial court dismissed the petition. On appeal, the Supreme Court of Iowa affirmed the judgement of the trial court. The court said:

> "The real issue in the case, as we see it, is whether the practice or business of embalming by a corporation, that acts through licensed embalmers, is prohibited by law or contrary to public policy."

The association was incorporated under Section 8486 of Chapter 390 of the 1937 Code of Iowa, which provides for the organization of cooperative associations for the purpose of "conducting any agricultural, live stock, horticultural, dairy, mercantile, mining, manufacturing, or mechanical business * * *."

The Attorney General of the State argued that a burial association could not lawfully be incorporated under the language just quoted, but the court held that it was a mercantile association.

The Attorney General argued that embalming was a profession, and that only persons who passed the requisite examinitions might obtain licenses to practice embalming and engage in doing so. In brief, the Attorney General argued that "a corporation cannot practice a licensed profession." In answer to this argument the court said:

> "We have stated that the formation of a cooperative burial association was within the contemplation of the general statutes authorizing cooperatives. It would be inconsistent to hold that a cooperative burial association was contemplated by Chap. 390, governing the formation of cooperatives, but such a cooperative could not carry out the purpose for which it was organized because embalming, as a licensed profession under Chap. 124.1, Code of 1939, cannot be performed by a corporation.
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> "There is no general rule that a corporation cannot own a business, the conduct of which requires licensed operators. The rule is that a corporation cannot in general practice one of the learned professions. 19 C.J.S., Corporations, § 956, p. 400. The rule is thus stated in 13 Am. Jr. 838, sec. 837:
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> > 'While a corporation is in some sense a person and for many purposes is so considered, yet, as regards the learned professions which can only be practiced by persons who have received a license to do so after an examination as to their knowledge of the subject, it is recognized that a corporation cannot be licensed to practice such a profession.'

"We gave expression to this rule in State v. Bailey Dental Co., 211 Iowa 781, 234 N.W. 260, and in State v. Kindy Optical Co., supra, when we held a corporation could not practice dentistry or optometry. See, also, State v. Superior Court for Chelan County, 17 Wash.2d 323, 135 P.2d 839; Kendall v. Beiling, 295 Ky. 782, 175 S.W.2d 489. In Cummings v. Pennsylvania Fire Ins. Co., 153 Iowa 579, 134 N.W. 79, 82, 37 L.R.A., N.S., 1169, Ann.Cas.1913E, 235, we quoted the dictionary definition of 'profession' in part as follows:

> 'Formerly theology, law and medicine were specifically known as the professions; but, as the applications of science and learning are extended to other departments of affairs, other vocations also receive the name. The word implies professed attainments in special knowledge, as distinguished from mere skill; a practical dealing with affairs, as distinguished from mere study or investigation; and an application of such knowledge to uses for others as a vocation, as distinguished from its pursuit for one's own purposes.'

"The rule with respect to a trade or business is thus stated in 13 Am. Jur. 839, sec. 838:

> 'In cases of trades or businesses for which a license is required in order to authorize a person to engage therein, it is generally held that a corporation may be so licensed * * *.'"

As indicated, the court held that one engaged in embalming was not practicing a profession. In reaching this conclusion the court referred to the case of Building Commissioner of Town of Brookline v. McManus, 263 Mass. 270, 100 N.E. 887, and quoted the following from the opinion in that case:

> "'Undertaking, as commonly carried on, is not a profession; it is a business or occupation. It has been held that the working tools of an undertaker are not professional instruments. O'Reilly v. Erlanger, 108 App. Div. 318, 95 N.Y.S. 760. See, also, Rowland v. Miller, 139 N.Y. 93, 34 N.E. 765. 22 E.R.A. 182. An undertaker is required to be licensed by a board of health under G.L. c. 114, § 49. An embalmer is also required to be registered under G.L. c. 112, §§ 82, 87. The fact that before a person can lawfully engage in the business of embalming he is required to submit to examination and be registered does not change business into something else any more than the occupation of others are changed by the requirement that they be licensed. See Wyeth v. Board of Health of Cambridge, 200 Mass. 474, 86 N.E.925, 23 L.R.A., N.S., 147, 128 Am.St.Rep. 439.'"

The court further said:

"It is our conclusion that the practice of embalming as defined and licensed in Chapter 124.1, Code of 1939, is the engagement of a business, and consequently a corporation with licensed operators can carry on the business. We see no legislative intent in the statutes to prevent the conduct of such business by a corporation.

"As long as the corporation performs embalming service by licensed embalmers we cannot see how the activities of the corporation will contravene the public policy of this state. In Liggett Co. v Baldridge, 278 U.S. 105, 49 S.Ct. 57, 59, 73 L.Ed. 204, the Supreme Court of the United States had before it the constitutionality of a Pennsylvania statute requiring the stock in corporations owning drug stores to be owned by licensed pharmacists. The court held the statute unconstitutional and in response to the argument that it was a legitimate public health measure, stated:

> 'It deals in terms only with ownership * * *mere stock ownership in a corporation, owning and operating a drug store, can have no real or substantial relation to the public health * * *.'"

Unincorporated Association Lacked Capacity To Sue

The case of Kadota Fig Association v. Case-Swayne Company, decided by a District Court of Appeals of California, 167 P.2d 518, illustrates the handicaps that an unincorporated association has in attempting to maintain a suit. This unincorporated association had not filed a certificate required by Sections 2466 and 2468 of the Civil Code of California, and because of its failure to file this certificate which such unincorporated associations were required to file, the trial court dismissed the action brought by the association on the ground that it lacked the capacity to sue.

The trial court held, and on appeal its judgment was affirmed, that the unincorporated association must be treated as a copartnership "and is therefore required to comply with the statute by filing the certificate disclosing the names of its members."

It was apparently argued that the association was a business or Massachusetts trust, but the court held that inasmuch as its "directors are subject to replacement and election by the shareholders", it was not a true or pure trust.

The association contended that inasmuch as it was an "unincorporated agricultural association organized under the federal Capper-Volstead Act, 7 U.S.C.A. § 291, it is exempt from the provisions of sections 2466 and 2468 of the Civil Code of California". But the court pointed out that the Capper-Volstead Act does not require associations to be incorporated, and of course there is no way of incorporating under the Capper-Volstead Act. All that an association may do is organize with or without incorporating in such a manner as to be consistent with the terms and conditions of the Capper-Volstead Act.

As pointed out above, this unincorporated association was required by the California law to file a certificate giving the names of all of its members before it would be qualified to bring a suit in California. In support of its position that the association could not maintain a suit without filing the certificate required by the statute giving the name of all of its members, the appellate court said in part:

> "It is true that two or more persons who are associated to do business 'under a common name' may be sued under such common name whether it contains the names of the associates or not. C.C.P., sec. 388. But that section does not authorize such persons to institute and maintain an action, as plaintiffs, under their business name which fails to disclose the individual members. Section 2468 of the Civil Code merely prohibits persons doing business under a fictitious name from maintaining an action without complying therewith and with section 2466 of the same code. The statute is relaxed with respect to suits against such persons conducting business in a common name. But that modification does not apply to plaintiffs who seek to maintain an action against other persons. In the case of Ginsberg Tile Co. v. Faraone, 99 Cal.App. 381, at page 384, 278 P. 866, at page 867, the court says:

'But it will be noted that the rule was relaxed with respect to defendants only. Had the Legislature intended to authorize or sanction a procedure such as that attempted here, obviously it would have been necessary simply to have provided that "the associates may sue or be sued by such common name."'"

It will be remembered that at common law an unincorporated association cannot maintain an action in its own name, but must sue in the names of all the members composing it, however numerous they may be. See Newton County Farmers & Fruit Growers Exchange v. Kansas City Southern Railway Co., 326 Mo. 617, 31 S.W.2d 803. Likewise, such an association in the absence of a statute cannot be sued in its society name, but the individual members must be sued. See Allis-Chalmers Co. v. Iron Molders' Union No. 125, 150 F. 155.

In general, of course, the liability of members of an unincorporated business association of third persons is the same as that of partners. See Houghton v. Grimes, 100 Vt. 99, 135 A. 15. In other words, an individual member of an unincorporated business association may ordinarily be held personally liable for all the indebtedness of the association. See 5 C.J. 1362, 1376.

In the absence of a statute an unincorporated association, unlike a corporation, is ordinarily incapable as an organization of taking or holding either real or personal property in its own name. See Idaho Apple Growers Association v. Brown, 50 Idaho 34, 293 P. 320; 51 Idaho 540, 7 P.2d 591.

Kadota Fig Association v. Case-Swayne Company, 167 P.2d 523, and Kadota Fig Association v. Case-Swayne Company, 167 P.2d 529, are companion cases to the principal case discussed above.

In the case of Demello et al. v. Dairyman's Co-operative Creamery, (Cal.App.) 167 P.2d 226, the plaintiffs brought suit against the cooperative creamery for the purpose of obtaining a declaratory judgment with respect to their interests in the defendant cooperative. The cooperative was organized in 1909 and each member was required to pay a membership fee of $100.00 on which a dividend of not to exceed 8 percent per annum was paid until the reorganization of the cooperative in 1944.

The creamery handled the dairy products of its members and also of nonmembers. It paid its patrons, member and nonmembers, the going market price of dairy products, except that during its early years it paid nonmembers 1 cent less for whole milk and 2 cents less for cream than it paid to members. At the close of each year, after making certain deductions for expenditures for plant expansion and betterments, for the amount of the monthly payments made for dairy products, and the dividend of 8 percent paid on the $100.00 membership of each member and a deduction to cover operating costs and expenses, the balance was divided among the members and nonmembers on a patronage basis.

> "The by-laws provided that a member should receive back his $100 on withdrawing; that en expulsion he sould receive his proportionate share in the net worth of the creamery; that on death the member's estate should be paid the worth of the share, such worth to be determined by the directors. Thus, except in case of death or expulsion, a withdrawing member would receive the $100 paid in by him and the creamery would retain any increase in its capital assets derived from its operations.
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> "Numerous members went out of the dairying business and others marketed their products elsewhere without withdrawing from the creamery and surrendering their certificates, thus retaining their voting rights. In January, 1944, there were 426 members with only about 150 of them delivering their products to the creamery and about 550 nonmembers delivering their milk and cream there. This situation caused internal dissension. Also after 1933, the creamery was compelled to pay federal income taxes."

In January 1944 the board of directors of the cooperative, with the approval and written consent of two-thirds of the members, reorganized the creamery with the view of making it a truly nonprofit cooperative marketing assocation. No question was presented regarding the regularity and legality of the reorganization proceedings. Among other things auditors for the creamery determined its net worth and this was apportioned among the members so that the value of the share of each member in the net worth was fixed at $1,065, for which amount each member was given a credit on the books of the association. No question was raised in the suit as to the correctness of the amount of the credits.

"In the by-laws of the association two revolving funds were set up to retire this indebtedness. The first was called the 'Revolving Fund' and was intended to retire $400 of this indebtedness to each member, the other was called the 'Secondary Revolving Fund' out of which was to be paid the balance of $650 to each member. Interest could be computed and paid on the $400 but the by-laws are silent as to interest on the balance. There is testimony indicating that in setting up the financial affairs of the association it was intended that the indebtedness to each member of the creamery be paid in not more than ten years. There is also testimony to the effect that the members could not be paid in full without the dissolution of the association.

"An initial payment of $100 to each member on account of the revolving fund indebtedness was offered at the time of the reorganization. This was refused by the plaintiffs and their assignors who brought this action to compel the association to pay each one of them the full amount of $1,065. Judgment went for defendant and this appeal followed."

It was the theory of the plaintiffs that they were forced out of the association by the reorganization and that each of them was entitled to an immediate payment of $1,065 each. In affirming the judgment of the trial court denying the plaintiffs relief, the appellate court pointed out that the plaintiffs had not been forced out of the association and that they could have continued as members thereof.

Attention is called to the fact that by the specific terms of the bylaws, a member on withdrawing was entitled only to $100 and that it was only on death or expulsion that he was entitled to his "proportionate share in the net worth of the creamery." In this regard the court said:

"As they had not been expelled and were living, all that any of them could demand on withdrawing from membership under the by-laws of the creamery was $100. On the reorganization each was offered immediate repayment of $100 and a credit of an additional $965 to be paid over a period of years. Thus under the reorganization plan each member will ultimately receive $965 more than he could have expected had the reorganization not been completed and had he withdrawn from the creamery."

There are a number of unusual features about this case. In the first place it is quite unusual for nonstock cooperatives to pay interest or dividends on membership fees. The fact that the cooperative during its early years paid nonmembers less than it paid members was undoubtedly the reason, or one of them, that the cooperative was denied exemption from the payment of income taxes.

The importance of having provisions in organization papers under which an association may suspend the rights of a member to vote and may terminate his membership for lack of patronage is emphasized by this case. As pointed out above, in January 1944 while the association had 426 members, only 150 of them were delivering their products to the creamery, while about 550 nonmembers were engaged in patronizing the association. From the standpoint of exemption from

the payment of Federal income taxes the voting members of an association should be its patrons, and if a situation develops in which a substantial number of the voting members of an association, although all of them are producers, are not patronizing an association it raises a question regarding the eligibility of the association for exemption from the payment of Federal income taxes.

The fact that each member was determined to have an interest in the amount of $1,065 in the net worth of the association at the time of reorganization strongly suggests that the association prior to that time had not been functioning on a true cooperative basis, because the net worth of the association arose, it is assumed, aside from the $100 membership fee paid by each member, from the patronage of each member and nonmember. Undoubtedly there were great differences in the amount of the patronage of the various members.

In a true cooperative organization at least the amount arising from patronage allocable to each member would have been determined as nearly as possible on a patronage basis, which would undoubtedly have resulted in some members having a larger interest in the net worth of the association than other members. In a true cooperative association money arising from the patronage of one patron may not be paid or credited to another patron.

Generally speaking, the courts hold that members are entitled to amounts contingently credited to them only in accordance with the provisions of the organization papers. See Reinert v. California Almond Growers Exchange, 9 Cal. 2d 181, 63 P 2d 1114, 70 P.2d 190, Summary No. 8, page 9; Driscoll v. East-West Dairymen's Association, 52 Cal. App.2d 468, 126 P. 2d 467, Summary No. 16, page 1.